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## ***TAX ISSUES FOR ARTISTS***

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Mr. Botwinick is a frequent lecturer for the New Jersey Institute of Continuing Legal Education, and has published articles in the New Jersey Law Journal and other publications. He has been named a Super Lawyer by New Jersey Monthly Magazine for the past six years.

Mr. Botwinick was awarded a B.S. degree in Accounting from the University of Florida, a J.D. with honors from Rutgers University School of Law, and an LL.M. degree in Taxation from the New York University School of Law. In 2006, Mr. Botwinick was named to the prestigious "40 Under 40" issue of the New Jersey Law Journal, a publication profiling attorneys who have distinguished themselves as leaders in their respective fields of law at a young age. In 2006, Mr. Botwinick was elected as a Fellow of the American College of Trust and Estate Counsel, a national peer-nominated organization of attorneys who have demonstrated the highest level of integrity, commitment to the profession, competence and experience as trust and estate counselors. He is currently the youngest lawyer in the State of New Jersey with that distinction.

Mr. Botwinick is the President of the Estate Planning Council of Northern New Jersey. He was formerly a trustee of the Jewish Community Foundation of Metro West New Jersey. He currently serves on the Board of The Grotta Fund, and was recently appointed by Governor Christie to the Board of the New Jersey-Israel Commission.

## I. INCOME TAXES

- A. **Introduction to Income Tax Issues.** The income tax treatment of the results of an artist or author's personal efforts is one of the most important issues that an artist deals with on a regular basis. The biggest tax issue that is typically of concern to the artist is whether the proceeds from the sale of the artist's work is consider the type of income referred to as "ordinary income," or the proceeds from the sale of a capital assets and, thus, "capital gain." The distinction between the two categories of income will affect the artist's rate of tax as well as his or her "earned income," which in turn is important in planning for self-employment taxes, contributions to qualified retirement plans and for foreign income purposes. Another important income tax issue is the treatment of expenses incurred in the artistic effort and whether the expenses are deductible, capitalized or neither.
- B. **"Trade or Business" vs. Hobby.** This is the most important threshold question for artists.
1. *Hobby:* If an artist is engaged in a hobby, rather than in a "trade or business" are only allowed to deduct expenses to the extent that the gross income derived from such activities for the taxable year exceeds the expenses. Internal Revenue Code Section (IRC §183). This rule is typically referred to as the "hobby loss rule."
  2. *Trade or business:* If an artist is determined to be engaged for profit in the artistic endeavors, deductible expenses can exceed income. IRC §§ 162 and 165.
  3. *Factors for Classification:* The following factors, although not all inclusive, may help you to determine whether your activity is an activity engaged in for profit or a hobby:
    - Does the time and effort put into the activity indicate an intention to make a profit?
    - Do you depend on income from the activity?
    - If there are losses, are they due to circumstances beyond your control or did they occur in the start-up phase of the business?
    - Have you changed methods of operation to improve profitability?
    - Do you have the knowledge needed to carry on the activity as a successful business?
    - Have you made a profit in similar activities in the past?

- Does the activity make a profit in some years?
- Do you expect to make a profit in the future from the appreciation of assets used in the activity?

**An activity is presumed to be “for profit” if it makes a profit in at least three of the last five tax years, including the current year.**

**C. Ordinary Income or Capital Gain.** Federal income taxes are imposed at different rates depending upon whether the proceeds are considered ordinary income or capital gains.

1. *Ordinary income* – Proceeds from the sale of an asset that is not a capital asset, or from an individual’s personal services. Generally defined as income other than *capital gain* proceeds. Ordinary income derived from artistic services is taxed at Federal rates of 10% to 35%.
2. *Capital Gain* – Proceeds derived from the sale of a capital asset. Typically, monetary gains acquired through the exchange of property, businesses and financial instruments requiring capital. Examples of capital gains include money acquired through the sale of real property, stocks, and businesses. Short term capital gains (assets held for less than one year) are taxed as ordinary income. Long term capital gains are taxed at favorable rates from 0% to 15%.
3. Sales of artwork by the artist who created the work are taxed as ordinary income, because the artwork is not considered a capital asset in the artist’s hands. IRC §1221(a)(3).
4. **What if the artist trades his artistic effort for items other than cash?** This is also ordinary income the value of which is equal to value of the items received in exchange.

**D. Contributions to Charity.** Generally, if an artist donates his artistic creations to a charitable organization, the artist can only deduct the costs associated with the creation of the donated items and not the fair market value (or what the artistic item would fetch in a public sale) as a charitable contribution.

## II. SALES TAX

**A. Doing Business in New Jersey.** Sellers doing business in New Jersey must comply with the State’s tax laws whether they sell their products from shops, at flea markets, at craft shows, by mail, or from home. All sellers, even seasonal businesses, are

required to register with the State for tax purposes at least 15 business days before starting business. To register, a Business Registration Application (Form NJ-REG) must be filed. Form NJ-REG may be filed online through the Division of Revenue's New Jersey Business Gateway Registry Services at: [www.state.nj.us/treasury/revenue/](http://www.state.nj.us/treasury/revenue/). If the application indicates that the business will collect sales tax or purchase materials for resale, a New Jersey Certificate of Authority (Form CA-1) for sales tax is sent to the seller. This certificate provides authorization from the State of New Jersey to collect sales tax and to issue or accept exemption certificates, and it must be displayed at the business location at all times. A seller must always be registered with New Jersey to accept exemption certificates. A Public Records Filing may also be required depending upon the type of business ownership. More information on Public Records Filing is available in the New Jersey Registration Package (NJ REG) or by calling 609-292-9292.

- B. Obligation to Collect and Remit Sales Tax.** New Jersey imposes a 7% tax on every retail sale of tangible personal property or digital property and the sale of certain services within this State, except as otherwise provided in the Sales and Use Tax Act (e.g., most clothing and footwear are exempt). Arts and crafts business owners registered in New Jersey who sell taxable items must collect sales tax on all taxable transactions and remit it to New Jersey.
- C. Retail Sales.** Sellers must collect sales tax on the purchase price, including delivery charges, of all taxable items sold if the retail customer (end user) or someone acting for the customer picks up the merchandise in New Jersey or asks to have it shipped to a New Jersey address, even if the items are later shipped out of New Jersey.  
*Exception:* Delivery to a package shipper or freight company located in New Jersey who will in turn ship the item out of State. Items shipped to a destination outside New Jersey are generally not subject to New Jersey sales tax.
- D. Sales to Other Businesses for Resale.** If another registered business purchases a product for resale, the purchaser is not considered to be the end user and no tax is due if the purchaser provides a valid Resale Certificate (Form ST-3) or Streamlined Sales and Use Tax Certificate of Exemption (Form ST-SST). If the purchaser does not provide the seller with an exemption certificate, the seller must collect sales tax.
- E. Qualified Out-of-State Sellers.** Qualified out-of-State sellers may make tax-exempt purchases in New Jersey of goods and services purchased for resale. When the qualified out-of-State seller carries the goods away from the point of sale, or sends its own vehicle or messenger to pick them up in New Jersey, the qualified out-of-State seller may use the Resale Certificate for Non-New Jersey Sellers (Form ST-3NR) or Streamlined Sales and Use Tax Certificate of Exemption (Form ST-SST).
1. *“Qualified out-of-State sellers”* are sellers that: (1) are not registered with New Jersey; (2) are not required to be registered with New Jersey; and (3) are registered with another state.

2. An out-of-State seller may not use an ST-3NR unless the purchase qualifies for exemption under New Jersey law. If a qualified out-of-State business that is not registered in New Jersey makes a purchase and asks to have the product shipped directly to its customer in New Jersey, the out-of-State business may use the resale certificate of its home state. This drop-shipment transaction is the only time a New Jersey seller may accept an exemption certificate of another state. The out-of-State business may also use Form ST-3NR, Form ST-SST, or Uniform Sales and Use Tax Certificate – Multijurisdiction published by the Multistate Tax Commission.
3. If no resale certificate is provided, the seller must charge New Jersey sales tax.

**F. Exempt Organizations.** Many churches, hospitals, volunteer fire departments, and other nonprofit organizations are exempt from paying sales tax on items purchased for the exclusive use of the organization. The Division of Taxation issues an Exempt Organization Certificate (Form ST-5) to those organizations which qualify for exempt status. *When selling products to these organizations, the seller must obtain a photocopy of their ST-5 certificate to document why sales tax was not collected.*

**G. Purchases.**

1. **Materials.** When sellers buy materials which will become a component part of the products that they make and sell, they may use a valid resale certificate instead of paying sales tax.
2. **Supplies and Tools.** Sales tax must be paid on purchases of supplies and tools. Items such as paint brushes, knives, scissors, tools, detergents, and disposable paper products for business use differ from materials because they do not become component parts of the finished product.

**Example:** Amy designs and makes hand-crafted wooden toys and sells them at a local flea market. She may issue a valid resale certificate to her New Jersey supplier when she buys the wood, nails, string, paint, and glue that ultimately become part of the toys she sells. She does not pay sales tax on these materials. However, Amy may not use a resale certificate when purchasing the paint brushes and scissors she needs to make her toys since the tools do not become component parts of her finished product. She must pay sales tax on the tools.

3. **Packaging/Wrapping.** Nonreturnable items used to contain, protect, wrap, and ship products to customers are exempt from New Jersey sales tax. To qualify for exemption, the packaging items must be incidental to the delivery of the products and an Exempt Use Certificate (Form ST-4) or Streamlined Sales and Use Tax Certificate of Exemption (Form ST-SST) must be provided to the supplier of the packaging items.

4. ***Production Equipment.*** Some machinery and equipment used directly and primarily in the production of tangible personal property by manufacturing, processing, assembling, or refining are also exempt. For example, a lathe used to make hand-crafted toys, or a sewing machine used by a clothing manufacturer, are types of exempt production equipment. By issuing Form ST-4 or Form ST-SST to the supplier, the purchaser would pay no sales tax on qualified equipment. For more information on exempt production equipment, see Tax Topic Bulletin S&U-6, Sales Tax Exemption Administration.

**H. Use Tax for Out-of-State Purchases.** If a seller buys supplies or tools outside New Jersey for use in this State, the seller owes 7% use tax to New Jersey if no sales tax was paid on the purchase. If sales tax was paid at a rate lower than 7% and the other state has sales tax reciprocity with New Jersey, the seller owes use tax on the difference between the amount of sales tax that would have been due in New Jersey and the amount of sales tax paid in the other state. This provision of the law protects home-State sellers from unfair competition. If materials that become a component part of the seller's product are purchased out of State, no use tax is due to New Jersey. For more information on New Jersey use tax, see publication ANJ-7, Use Tax in New Jersey. Note: If a seller buys materials with a valid resale certificate and decides to use them for personal purposes (and not to resell them), use tax at 7% of the purchase price must be remitted to New Jersey.

**I. New Jersey Division of Taxation Information.** The information contained in this outline, and active links to various forms mentioned in this outline can be found at the Division of Taxation's website at this address:

**<http://www.state.nj.us/treasury/taxation/pdf/pubs/sales/anj11.pdf>**

### **III. ESTATE AND GIFT TAXES**

**A. Basic Overview of Estate Taxes.** Current law allows every individual an exemption from Federal estate taxes based upon the overall value of the deceased individual's estate. The current exemption is \$5,120,000. However, the exemption will drop to just over \$1,000,000 on January 1, 2013, if Congress does not act before then. The New Jersey estate tax exemption is a mere \$675,000 and that figure is not scheduled to increase at any time in the future. Bequests to a surviving spouse who is a U.S. Citizen are completely exempt from both U.S. and New Jersey estate taxes.

**B. Overview of Gift Taxes.** Current law allows every individual to make taxable gifts over his lifetime of up to \$5,000,000 before imposing a gift tax. Taxable gifts below \$5,000,000 (other than annual exclusion gifts, currently \$13,000/year/beneficiary) will, however, consume not only the gift tax exemption, but also the estate tax exemption. This means that an individual can make lifetime gifts and bequests of up to \$5,000,000 in the aggregate, but once the exemption is fully consumed, gifts and bequests will be taxed at a current rate of 35%.

- C. **Rates.** Currently, Federal estate tax is imposed at the rate of 35% on amounts over the exemption. The New Jersey estate tax is a progressive tax, meaning that the more you pass on, the higher the tax rate. The New Jersey estate tax rate generally varies from 0% to 16% depending upon the amount of the transfer. However, through a quirk in the system, the first \$52,175 over \$675,000 is taxed at a 37% rate.
- D. **Valuation.** Under both the Federal and the New Jersey estate tax systems, the taxes are imposed against the “fair market value” of the estate. “Fair market value” is defined as *“the amount at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”*
1. **Valuation of an artist’s estate.** When computing the fair market value of a deceased artist’s estate, the artistic items which the artist has produced are valued at what the items would fetch at a gallery or similar sale. This is true even if the artist would only have been able to sell the item to the gallery for 50% of the full retail value. See Estate of David Smith, 57 T.C. 650, acquiesced in, I.R.B. 1974-27. The recipient of the art will, however, take a basis in the art equal to its fair market value, which should reduce and/or eliminate the recognition of any gain on the subsequent sale.
  2. **Gifts.** Like the estate tax, the value of a gift for gift tax purposes is the fair market value.
    - i. The donee of the gift takes the basis of the art in the artist’s hands (not the fair market value). This means that if the donee sells the art, any gain would be measured as the difference between the proceeds and his basis.
    - ii. The character of the tax treatment of the proceeds of the sale of these gifted works of art is the same as in the artist’s hands. This means that if the donor artist created the artwork, the income will be ordinary income to the seller.

#### IV. TAX ISSUES FOR COLLECTORS

A. **Income Tax on Sales of Art.** Collectors, dealers and art investors are treated differently for income tax purposes.

1. ***Dealers*** – Dealers are individuals who hold art primarily for sale to customers in the ordinary course of business. They are generally entitled to deduct their ordinary business expenses for income tax purposes.
2. ***Investors*** – Investors purchase artwork primarily for appreciation; the primary objective is to make money. Expenses incurred in connection with the investment activities are deductible by the investor only to the extent that the total of all of the expenses exceeds 2% of the investor's adjusted gross income.
3. ***Collectors*** – Collectors acquire artwork for their own personal pleasure. Expenses incurred by a collector are treated the same as hobby loss rules.

B. **Capital Gains.** Losses incurred by a collector as a result of the sale of artwork are not deductible as capital losses. However, gains recognized on the sale of artwork by a collector are treated as capital gains.

C. **Collector and Dealer.**

1. A taxpayer can be an art dealer with respect to one piece of art and an art collector with respect to another. Income and expenses must be separately accounted for.
2. It is important for an art dealer to be able to identify when he is acting as a dealer and when he is a collector. The line between the two should be identifiable. For example, the art which an individual holds as a dealer is displayed or stored somewhere different from where the collectible artwork is located. There may also be two separate insurance policies – one for the collection and one for the inventory.

## V. TAX DIFFERENCES BETWEEN ENTITIES

- A. **Choice of Entity.** When you start a business you have to make a choice as to the form of entity in which to operate. Depending upon the choice you make, there can be significant tax differences. In fact, the tax treatment of the entity is usually the primary motivating factor in determining the form of entity to select.
1. ***Sole proprietorship.*** The business and the owner are legally the same. From the IRS's perspective, the business is not a taxable entity. Instead, all of the business assets and liabilities and income are treated as belonging directly to the business owner.
  2. ***General partnership.*** When two or more individuals intend to operate a business as co-owners, they cannot be a sole proprietorship. However, they can operate as a partnership. Similar to a sole proprietorship, the business and the owners (two or more) are legally the same. This means that a partnership is not a taxable entity under federal law. There is no separate partnership income tax, as there is a corporate income tax. This type of entity is typically referred to as a “pass-through entity.” Income from the partnership is taxed to the individual partners, at their own individual tax rates. For tax purposes, all of the income of the partnership must be reported as “passed-through” to the partners, who will then be taxed on it through their individual returns.
  3. ***C corporation.*** A corporation is a legal entity which is separate from its owners. It is created by a state filing, typically with the Secretary of State. A “C corporation” is subject to corporate income tax. This is different from a sole proprietorship and partnerships. Income earned by a C corporation is normally taxed at the corporate level using the corporate income tax rates. Distributions from the C Corporation to its shareholders is called a dividend. C corporation income is said to be subject to what is called “double taxation.” This is because the C Corporation pays taxes on its income, but does not get a deduction for distributions to its shareholders. When the shareholder received the dividend, the shareholder pays taxes on that distribution of profits. Thus the “double-taxation” – tax at the corporate level and again at the shareholder level.
  4. ***Limited liability company (LLC).*** This is a legal entity separate from the individual or individuals who establish the entity. It is created by a state filing. Each state has its own LLC laws. LLCs are really a hybrid type of entity because, while owners are given the liability protection that was previously afforded only to shareholders of a corporation, LLCs are treated like partnerships for federal tax purposes. This means that LLCs have the “pass-through” tax treatment of a general partnership, which means that no tax on the LLC’s income is paid at the business level. Income and losses are reported on the personal tax returns of the owners, and any tax due is paid at the individual level.

5. ***S corporation.*** An S corporation is a corporation that has filed a special election with the IRS and/or the State in which it was formed to be treated in a manner similar to a partnership (or LLC) for tax purposes. In other words, an S Corporation is a corporation with pass-through tax treatment, rather than the corporate level of taxation with distributions treated as taxable dividends. Thus, an S Corporation can avoid double-taxation.

## VI. TAX AUDITS/NOTICE FROM TAX AUTHORITIES

### A. What do I do when I get a notice from the IRS?

- Don't panic – often a notice from the IRS is simply looking for information to confirm something on a return or to notify you of a mathematical mistake on a return
- If you get a correction notice, you should confirm whether the IRS is correct in their determination by comparing it to your return
- Often, if the IRS has made a correction that you agree with, you may not need to do anything. Read the letter very carefully.
- If you disagree with the IRS's determination, you have the right to appeal the determination. You may be able to do this on your own, but you may wish to employ a CPA or tax attorney to assist you. **PLEASE BE VERY CAREFUL TO COMPLY WITH THE TIME REQUIREMENTS FOR RESPONDING AS OFTEN THERE IS NO FLEXIBILITY IN THESE DATES.**
- Keep copies of everything which you exchange with the IRS.

### B. What do I do if I am contacted by the New Jersey Division of Taxation?

- Much of the advice set forth above applies equally to New Jersey taxation
- If the notice deals with Sales Tax, determine if a mistake has been made on your own part.
- You may go to the Division of Taxation's website which includes detailed information regarding what items are subject to New Jersey Sales Tax and what items are not.
- Again, there are very specific timeframes which you must honor if you disagree with the Division's position. A late response may foreclose you from pleading your case, even if you are correct.
- In most cases, a simple resolution can be very easy.

### C. What do I do if a Special Agent from the IRS contacts me.

- Special Agents are employed in the IRS office of Criminal Investigations
- If you are the target of an investigation, you should contact an attorney immediately and you should not speak with the agent without the benefit of counsel
- Keep in mind that if you are the target of the investigation, at the point in time when you get a visit, the IRS has already done some serious investigating without you knowing about it. They are not going to be convinced by half-truths and false stories.